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United States General Accounting Office

GAO

Report to the Chairman, Subcommittee on Military Readiness, Committee on National Security, House of Representatives

June 1998

AIR FORCE SUPPLY MANAGEMENT

Analysis of Activity Group's Financial Reports, Prices, and Cash Management

GAO/AIMD/NSIAD-98-118

GAO United States
General Accounting Office
Washington, D.C. 20548

Accounting and Information
Management Division

B-278060

June 8, 1998

The Honorable Herbert H. Bateman
Chairman, Subcommittee on Military Readiness
Committee on National Security
House of Representatives

Dear Mr. Chairman:

This report, one in a series[1] you requested on the financial operations of the Department of Defense's (DOD) Working Capital Funds, addresses the Air Force supply management activity group. This supply management activity group supports combat readiness by procuring critical material and making repair parts available to its customers such as military units. The group operates under the working capital fund concept, where customers are to be charged the costs of providing goods and services to them. During fiscal year 1997, the group was responsible for inventory with a reported value of about $24.5 billion.

As requested, this report discusses (1) the accuracy and consistency of the Air Force supply management activity group's accounting and budgetary reports, (2) the group's price-setting process, and (3) the Air Force Working Capital Fund's cash management practices.

We are sending copies of this report to the Ranking Minority Member of your Subcommittee; the Chairmen and Ranking Minority Members of the Senate Committee on Armed Services; the Senate Committee on Appropriations, Subcommittee on Defense; the House Committee on Appropriations, Subcommittee on National Security; the Senate and House Committees on the Budget; the Secretary of Defense; the Secretary of the Air Force; and the Director of the Defense Finance and Accounting Service. Copies will also be made available to others upon

[1]We issued two reports on the Navy Ordnance activity group (GAO/AIMD/NSIAD-97-74, March 14, 1997, and GAO/AIMD/NSIAD-98-24, October 15, 1997).

request. If you have any questions about this report, please call Greg Pugnetti, Assistant Director, at (202) 512-6240. Other major contributors to this report are listed in appendix II.

Sincerely yours,

Jack L. Brock, Jr.
Director, Governmentwide and Defense Information Systems
Accounting and Information
Management Division

David R. Warren
Director, Defense Management
National Security and International
Affairs Division

Executive Summary

Purpose

The supply management activity group is the Air Force's primary purchaser of inventory and the largest activity group in the Defense Working Capital Funds. In view of the group's significance to the working capital funds and Air Force readiness, the Chairman, Subcommittee on Military Readiness, House Committee on National Security, asked GAO to evaluate (1) the accuracy and consistency of the Air Force supply management activity group's accounting and budgetary reports, (2) the group's price-setting process, (3) the Air Force Working Capital Fund's cash management practices, including the practice of advance billing customers to maintain an adequate cash balance, and (4) the effectiveness of the supply management activity group in providing needed inventory items to customers in a timely manner. This report responds to the first three financial issues discussed above. GAO plans to issue a separate report on the fourth issue dealing with the group's effectiveness in meeting customers' needs.

Background

The Air Force supply management activity group provides about two million types of inventory items, including weapon system spare parts, fuels, and medical-dental supplies, to customers which consist primarily of DOD organizations.[1] DOD reported that the group had $24.5 billion in inventory at the end of fiscal year 1997 and about $12 billion in revenue from the sale of goods to its customers during fiscal year 1997. The group is part of the Air Force Working Capital Fund, a revolving fund that relies on sales revenue, rather than direct congressional appropriations, to finance its operations. Working capital funds are to (1) generate sufficient revenues to cover the full costs of their operations and (2) operate on a break-even basis over time—that is, not make a profit nor incur a loss. It is essential that the working capital funds operate efficiently since every dollar spent inefficiently results in less funds available for other defense spending priorities.

The Air Force supply management activity group generates revenue by selling customers inventory and billing them at predetermined prices (standard prices). Those prices, which typically are to be stable throughout the fiscal year, consist of two major elements: (1) the acquisition or repair cost of the inventory sold plus (2) operational costs, such as salaries and storage costs. In developing the prices for individual inventory items which are to reflect the full cost, the Air Force adds a surcharge to the acquisition cost or repair cost of items to recover the operational costs. Customers primarily use operations and maintenance

[1]The supply management activity group also sells inventory items to foreign governments.

appropriations to pay for the inventory items. Payments from customers replenish the cash balance in the Air Force Working Capital Fund, which is used to finance ongoing operations.

Results in Brief

The Air Force has had difficulties producing reliable financial information on the supply management activity group's operations, setting prices for inventory the group sells to customers, and generating sufficient cash to help discontinue the Air Force Working Capital Fund's practice of advance billing its customers since 1993. These weaknesses impair the Air Force's ability to (1) ensure that customers can purchase inventory items when needed and (2) achieve the goals of the working capital funds, which are to focus management attention on the full costs of carrying out operations and to manage those costs effectively.

At the core of many of the supply management activity group's financial management weaknesses is its inability to produce reliable information on its cost of goods sold and net operating results (the difference between annual revenue and expenses). This financial information is critical since the activity group must set prices that reflect the expected costs of providing inventory items to customers. If these data are inaccurate, the activity group's prices may not cover its full cost of operations or generate enough cash to pay its bills, which has been the case in recent years. Until the Air Force can (1) develop accurate information on the supply management activity group's net operating results and cost of goods sold, (2) use this information to develop an effective price-setting process that enables the supply management activity group to operate on a break-even basis and helps ensure that customers receive adequate funding to purchase needed inventory items, and (3) acquire and use management tools for projecting cash outlays, its customers will remain susceptible to wide price fluctuations and a corresponding depletion of funds. Further, the Air Force Working Capital Fund will have to continue to advance bill customers so that it has enough cash to pay its bills. Finally, senior managers and those responsible for providing oversight will continue to lack the information they need to make informed decisions on Air Force supply operations.

Principal Findings

Long-Standing Financial Reporting Problems Continue

GAO has previously reported[2] that DOD has had long-standing problems in preparing accurate financial reports on its working capital fund operations. DOD has frequently acknowledged that working capital funds' financial reports were inaccurate and cited actions being taken to correct this problem. GAO found that some of these actions have not yet been completed, and serious financial reporting problems still exist. The Air Force supply management activity group's net operating result and cost of goods sold information contained in DOD's monthly accounting reports and Chief Financial Officer reports sent to the Congress have consistently varied by billions of dollars. For example, the fiscal year 1996 net operating results reported in the monthly accounting report and the Chief Financial Officer report, which should agree with each other, differed by $4.2 billion. Further, the budget justification report reflected a third, different net operating result, which was not reconciled to the accounting reports. As a result, DOD, the Air Force, and the Congress have not received accurate information on the Air Force supply management activity group's net operating results—a critical piece of information since it is one factor used in setting prices to be charged to customers in subsequent years. The cost of goods sold represents the single largest expense to the activity group.

Congressional defense committees have raised concerns about the working capital funds' financial and management problems over the last several years. To improve the management of the working capital funds, the National Defense Authorization Act for Fiscal Year 1997 required DOD to develop a corrective action plan by September 30, 1997. GAO found that the plan DOD developed to address this requirement does not contain the specific steps that need to be taken to correct the problems. DOD officials told GAO that (1) they are identifying the detailed steps for correcting the problems addressed in the plan and (2) correcting many of the problems will require improving the existing accounting and logistical systems or developing new systems, which will take some time to show results.

[2]Defense Business Operations Fund: Management Issues Challenge Fund Implementation (GAO/AIMD-95-79, March 1, 1995); Defense Business Operations Fund: Improved Pricing Practices and Financial Reports Are Needed to Set Accurate Prices (GAO/AIMD-94-132, June 22, 1994); Financial Management: Status of the Defense Business Operations Fund (GAO/AIMD-94-80, March 9, 1994); and Letter to Congressional Committees on the Defense Business Operations Fund (GAO/AFMD-93-52R, March 1, 1993).

Difficulties Encountered in Developing Prices

Two objectives of the supply management activity group's price-setting process are to (1) establish prices for individual inventory items that are to reflect the expected full cost of providing these items to customers and (2) develop the activity group's composite, or aggregate, price change that is used in budgeting so that customers have the funds available to buy needed inventory items from the activity group. During the budget process, the composite price change is approved by the Under Secretary of Defense (Comptroller).

GAO found that the Air Force lacks controls to ensure the composite price change approved by the Under Secretary of Defense (Comptroller) during the budget process is properly implemented. For example, the supply management activity group's fiscal year 1997 prices for repairable inventory items were reduced by about 18 percent, effective April 1, 1997, when budget execution data showed that customers were spending much more than expected for purchases of inventory. According to Air Force officials, this problem occurred because the supply management activity group had to pay more than budgeted for repairing items, causing prices to the customers to be higher than those approved during the budget review process. Air Force officials told GAO that if they had not lowered prices in April 1997, their customers would have run out of funds before the end of the fiscal year.

Further, the Air Force revised its cost allocation procedures at the beginning of fiscal year 1998 to better match the group's estimated operational costs with the prices charged for individual inventory items. The activity group now estimates the costs associated with (1) individual supply activities—the five Air Logistics Centers—and allocates each Center's costs to only those items that the center manages and (2) procuring inventory items to replace items that can no longer be repaired and allocates the estimated replacement cost to the item being replaced. Prior to fiscal year 1998, all of the activity group's estimated operating costs were aggregated and then spread uniformly to all the items that the Air Force manages. The new procedure, together with the increased awareness of the need for reliable financial data, should eventually allow Air Force managers to better identify inefficient operations and activities and to make more informed decisions about managing the group's infrastructure costs.

However, the Air Force's ability to achieve these benefits is constrained by a lack of reliable data. For example, because it lacks reliable sales revenue and operational cost data for individual Air Logistics Centers, the Air

Force changed the amount of operating cost allocated to individual inventory items after prices were established for fiscal year 1998. This resulted in three different sets of prices for individual inventory items during fiscal year 1998. The Air Force's initial allocation of funding has left some customers with either too much or too little funding for purchasing needed items. Although Air Force headquarters can alleviate this problem by reallocating available funds, it lacks the reliable historical and budget execution data it needs to do so effectively.

Air Force Working Capital Fund and Supply Management Activity Group Cash Management Problems

GAO has previously reported that the working capital funds have had a long-standing cash management problem and have adopted the practice of advance billing customers. Since 1993, the funds have advance billed customers for work not yet performed in order to have enough cash to pay their bills. DOD initially expected the funds to generate sufficient cash to eliminate advance billing in fiscal year 1995. When this did not occur, DOD called for an end to advance billing in fiscal year 1996, and again in fiscal year 1997, in its working capital fund budgets. The Air Force had steadily reduced its working capital fund's outstanding advance billing balance from about $1.3 billion in February 1995 to $77 million in November 1996. However, to ensure that the fund's cash balance would remain positive, the Air Force advance billed customers over $1 billion in December 1996 and about $700 million in the June/July 1997 time period. As of the end of fiscal year 1997, the Air Force Working Capital Fund had an outstanding advance billing balance of $464 million. This working capital fund cash balance would have been a negative $340 million if the Air Force had not advance billed customers.

Since the Air Force maintains one cash balance at the overall Air Force Working Capital Fund level and the supply management activity group is responsible for more than half of the Fund's cash collections and disbursements, it is important that the Air Force supply management activity group properly manage cash. GAO found that the activity group did not accurately project cash collections from foreign military sales. Specifically, inaccurate projection of foreign military sales resulted in actual cash collections being about $429 million less than budgeted from fiscal year 1993 through fiscal year 1996. Air Force officials stated that they need better management tools, such as a cash forecasting model for projecting cash collections and disbursements. They also stated that they do not have the basic information for projecting cash outlays, such as item managers' projections on when items will be delivered from contractors and subsequent payment made to the contractors.

The Air Force recognizes that it has a cash problem and increased its working capital fund customer prices for fiscal years 1998 and 1999 to generate an additional estimated $275 million. If these price increases do not alleviate the cash problem, the Air Force may have to continue increasing prices to generate cash.

Recommendations

GAO is making recommendations to the Secretary of Defense and the Secretary of the Air Force for improving the Air Force supply management activity group's financial reporting, price-setting, and cash management practices. These recommendations focus on (1) developing a plan to improve the accuracy of the group's financial reports, especially the cost of goods sold and net operating results figures that are included in the financial reports, (2) developing procedures to ensure that approved prices are actually implemented and used to charge customers for inventory purchases, (3) assessing the impact of price changes on customers to determine whether goods are acquired by customers when needed and taking funding reallocation actions, as appropriate, and (4) improving the Air Force's cash management practices by developing a cash forecasting model that includes the capabilities to forecast required cash levels, end-of-period cash positions, and disbursements to be made in future years.

Agency Comments

In its written response to this report, DOD concurred with GAO's findings and recommendations and identified actions the Department and the Air Force are taking to correct the identified deficiencies. For example, DOD has begun considering ways to improve its method for calculating inventory valuations as well as to improve financial statement reporting. DOD further stated that the actions it is taking to implement GAO's recommendations should improve the reliability and accuracy of the Air Force's supply activity group's operations.

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Abbreviations

AFMC	Air Force Materiel Command
ALC	Air Logistics Center
DFAS	Defense Finance and Accounting Service
DOD	Department of Defense
FMS	Foreign Military Sales
GAO	General Accounting Office
SMAG	Supply Management Activity Group

Introduction

The Air Force supply management activity group (SMAG) helps to maintain combat readiness and sustainability by supplying the Air Force with items necessary to support troops, weapon systems, aircraft, communications systems, and other military equipment. In doing so, SMAG is responsible for about two million items, ranging from weapon system spare parts to fuels, food, medical and dental supplies and equipment, and uniforms. SMAG is the largest supply management activity in Defense—it reported $12 billion in revenue and $24.5 billion in inventory for fiscal year 1997.

SMAG operations are financed as part of the Air Force Working Capital Fund, which was formerly a part of the Defense Business Operations Fund. In December 1996, the Under Secretary of Defense (Comptroller) dissolved the Defense Business Operations Fund and created four working capital funds[1] to clearly establish the military services' and DOD components' responsibilities for managing the functional and financial aspects of their respective activity groups. The funds are to operate by charging customers the full costs of goods and services provided to them as currently defined in the Department of Defense's (DOD) Financial Management Regulation, Volume 11B, Reimbursable Operations, Policy and Procedures—Defense Business Operations Fund.

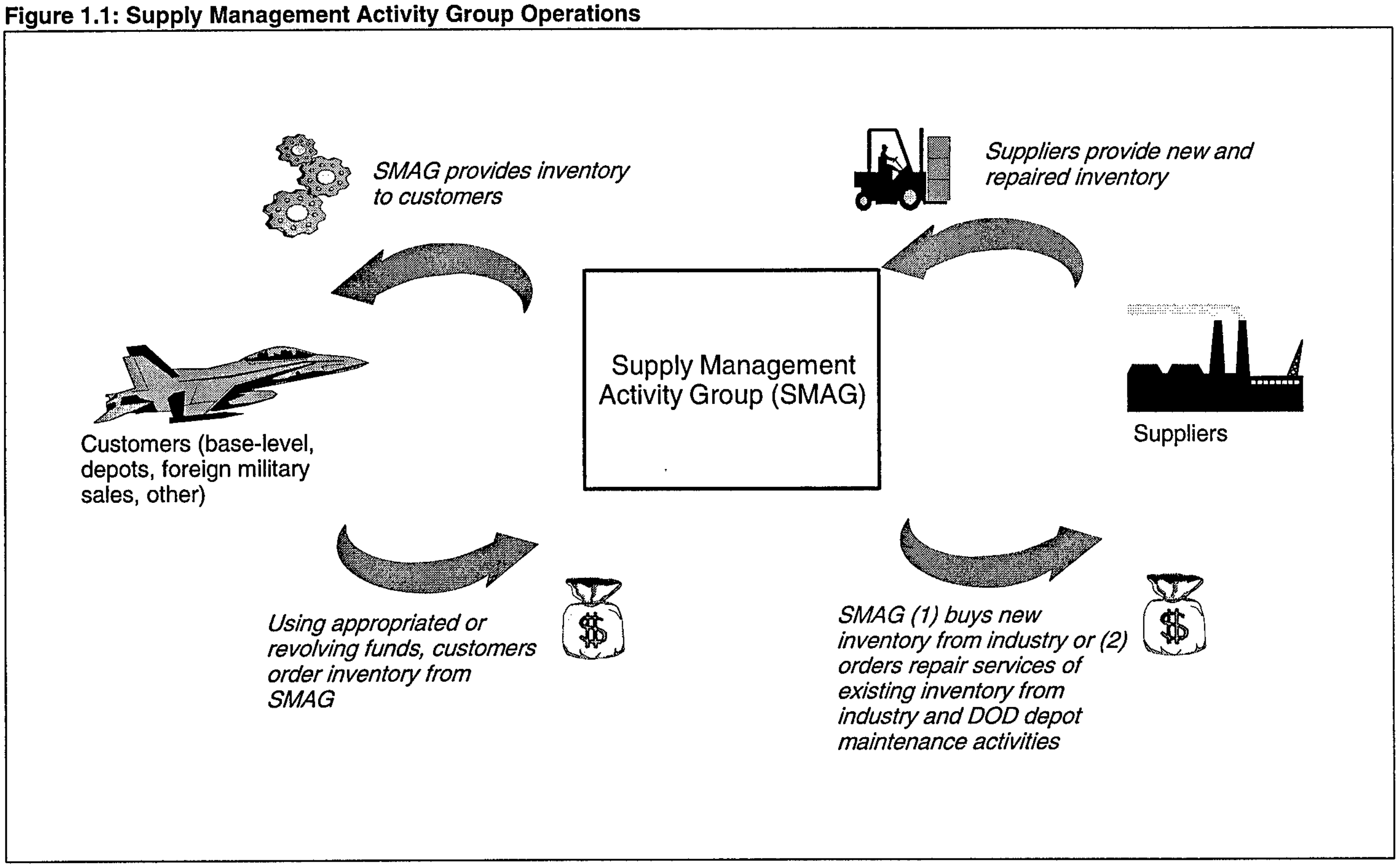
The primary goal of the current working capital fund financial structure is to focus the attention of all levels of management on the full costs of carrying out certain critical DOD business operations and the management of those costs. Unlike a private sector enterprise which has a profit motive, the four working capital funds are to operate on a break-even basis over time by recovering the full costs incurred in conducting the business operations. Accomplishing this requires DOD managers to become more conscious of operating costs and make fundamental improvements in how DOD conducts business since customers have a defined amount of funds to pay for goods and services. It is critical for the working capital funds to operate efficiently since every dollar spent inefficiently is one less dollar available for other defense spending priorities.

As figure 1.1 illustrates, SMAG receives orders from customers to purchase inventory items. Customers use appropriated funds, primarily Operation and Maintenance appropriations, to finance these orders. SMAG provides the inventory items to customers and bills customers on the basis of predetermined prices—commonly referred to as standard prices, which generally are to be in force throughout the entire fiscal year. SMAG uses payments from customers to replenish the inventory sold to customers by

[1]The four working capital funds are the Army, Navy, Air Force, and Defense-wide.

(1) buying new inventory items or (2) ordering repair services of existing inventory from industry and DOD depot maintenance activities as well as to cover operating costs. SMAG procures critical material and makes repair parts available to its customers through five inventory control points: Ogden Air Logistics Center (ALC), Ogden, Utah; Oklahoma City ALC, Oklahoma City, Oklahoma; Sacramento ALC, Sacramento, California; San Antonio ALC, San Antonio, Texas; and Warner Robins ALC, Warner Robins, Georgia.[2] The five ALCs report to the Air Force Materiel Command (AFMC), located at Dayton, Ohio.

Figure 1.1: Supply Management Activity Group Operations



Source: Department of the Air Force.

[2]The Air Force is in the process of closing the Sacramento and San Antonio ALCs based on the 1995 Base Realignment and Closure recommendations.

SMAG's operations are divided into two main categories: wholesale and retail. Wholesale operations encompass about 200,000 types of inventory items (generally weapon system related) for which the Air Force is the inventory control point. SMAG procures, manages, and sets the prices that customers will pay for these wholesale items. The wholesale prices include SMAG's operational support cost, such as civilian salaries and accounting costs. SMAG adds a surcharge to the acquisition cost or repair cost of the individual inventory items to recover its operating costs. SMAG retail inventory operations encompass items that are managed by the other services, Defense agencies,[3] or government agencies. These non-Air Force entities are the inventory control points for these items and, therefore, set the prices for these items. The retail portion of SMAG purchases these items from the non-Air Force entities and then resells them to customers.

Since fiscal year 1991, the composition of the inventory items and costs managed by SMAG has significantly changed, making it more complicated for SMAG to manage, budget, and account for inventory. Prior to fiscal year 1991, SMAG consisted of the following six divisions: (1) systems support, (2) general support, (3) fuels, (4) medical/dental, (5) commissary, and (6) the Air Force Academy Cadet Store. The systems support division—the only wholesale division—procured consumable items (items that are replaced rather than repaired) for aircraft, missiles, and their major components.

Beginning in fiscal year 1991, the Air Force added two new wholesale divisions to its stock fund operations: the reparable support and cost of operations divisions. The reparable support division procures depot level repairables and pays for the repair of these repairable inventory items. Managing repairable items was a new function for SMAG,[4] and it complicated the budgeting and accounting for inventory items since SMAG did not have any experience in setting prices to recover the cost to repair items. The cost of operations division included the overhead costs for the five inventory control points of the stock fund which also complicated matters for the stock fund since these costs were not previously captured and included in the prices charged customers. The effect of adding the repairable support and cost of operations divisions to the stock fund is significant. For example, in fiscal year 1997, the Air Force reported

[3]The Defense Logistics Agency manages most consumable items.

[4]Prior to fiscal year 1991, repairable items were not part of SMAG. The Air Force used procurement appropriations to centrally purchase repairable items and provided these items to customers free of charge. When an item needed repair, the customers returned the item and received a replacement item free of charge.

wholesale division sales of about $6.8 billion of which only a reported $500 million pertained to the systems support division—the only wholesale division that existed prior to fiscal year 1991.

Three other changes also impacted SMAG's operations.

- In fiscal year 1992, the commissary division was transferred from SMAG to the Defense Commissary Agency. The Air Force budgets show that the commissary division had estimated sales of $2.6 billion to $2.8 billion per year in the early 1990s.
- About 475,000 consumable items were transferred from the system support division to the Defense Logistics Agency from fiscal year 1992 through 1997. The transfer of these items significantly reduced the number of items managed by the systems support division to about 125,000 items.
- On October 1, 1997, the Air Force consolidated SMAG's three wholesale divisions into one wholesale division called the Materiel Support Division. The Air Force created the Materiel Support Division to provide better cost visibility. Now, the estimated costs associated with each ALC are included in the prices of inventory items they manage. Previously, these costs were spread across the board to all inventory items.

Objectives, Scope, and Methodology

The objectives of our review were to evaluate the (1) accuracy and consistency of SMAG's accounting and budgetary reports, (2) SMAG's price-setting process, and (3) Air Force Working Capital Fund's cash management practices, including the practice of advance billing customers.

To evaluate the accuracy and consistency of SMAG's accounting and budgetary reports, we (1) obtained and analyzed the Defense Working Capital Fund Accounting Report (1307), the Air Force Defense Business Operations Fund Chief Financial Officer Annual Financial Statement,[5] and the Air Force's Working Capital Fund budget justification report for fiscal years 1992 through 1996,[6] (2) interviewed Air Force and Defense Finance and Accounting Service (DFAS) officials to determine why reports covering the same period provided widely different results, and (3) analyzed the DOD Working Capital Fund report, dated September 1997, that was prepared in response to the National Defense Authorization Act for Fiscal Year 1997, to determine the actions DOD is planning to improve the

[5]In December 1996, DOD dissolved the Defense Business Operations Fund and created four working capital funds.

[6]The fiscal year 1996 reports were the most recent reports at the time of our work.

accuracy of the working capital fund's accounting report. We also met with DOD Inspector General and Air Force Audit Agency officials to discuss the accuracy of SMAG's financial reports.

The quantitative financial information used in this report on SMAG's financial operations was produced from DOD's systems—which have long been reported to generate unreliable data. We did not independently verify this information. The DOD Inspector General has cited system deficiencies and internal control weaknesses as major obstacles to the presentation of financial statements that would fairly present the Defense Business Operations Fund financial position for fiscal years 1993 through 1996.

To evaluate SMAG's price setting-process, we (1) obtained and analyzed the budget documents used in setting prices, (2) interviewed Air Force comptroller and program officials at Headquarters and AFMC to discuss the rationale for the various factors, including cost reduction goals, used to develop SMAG's prices charged customers, (3) analyzed documents on the new price-setting procedures and interviewed Air Force officials to determine if the Air Force encountered problems in implementing the new procedures, and (4) analyzed budget documents concerning prices and interviewed Air Force officials to determine why the Air Force changed the fiscal years 1997 and 1998 prices once they were implemented.

To evaluate the Air Force's Working Capital Fund's cash management practices, including its practice of advance billing customers, we (1) collected and analyzed financial information related to the cash balances, advance billings, collections, disbursements, accounts receivable, and accounts payable from fiscal year 1992 through fiscal year 1997, (2) obtained and analyzed DOD and Air Force guidance on managing cash, and (3) interviewed officials in the Office of the Under Secretary of Defense (Comptroller), Air Force Headquarters, and AFMC concerning the cash management practices and the Air Force's continual need to advance bill customers to alleviate the cash shortage problem. We also analyzed the DOD Working Capital Fund report, dated September 1997, that was prepared in response to the National Defense Authorization Act for Fiscal Year 1997, to determine the actions DOD is planning to improve the working capital fund's cash management practices. We did not independently verify the reported cash information.

We performed our work at the headquarters, Offices of the Under Secretary of Defense (Comptroller) and Air Force, Washington, D.C.; Air Force Materiel Command, Dayton, Ohio; the Sacramento Air Logistics

Center, Sacramento, California; Headquarters, Defense Finance and Accounting Service, Arlington, Virginia; Defense Finance and Accounting Service Denver Center, Denver, Colorado; Air Combat Command, Langley Air Force Base, Virginia; Air Mobility Command, Scott Air Force Base, Illinois; and Air Force Space Command, Peterson Air Force Base, Colorado. Our work was performed from August 1997 through May 1998, in accordance with generally accepted government auditing standards.

The Department of Defense provided written comments on a draft of this report. We incorporated DOD's comments where appropriate. These comments are discussed in chapters 2, 3, and 4 and are reprinted in appendix I.

Long-Standing Financial Reporting Problems Continue

We have previously reported that DOD has had long-standing problems in preparing accurate working capital fund financial reports, particularly with regard to the accuracy of net operating results (the difference between annual revenue and expenses). These data are critical in setting prices and ensuring that the funds break-even over time. The problems we identified were attributable to significant deficiencies in the working capital fund accounting systems as well as a lack of sound internal controls.

We found that these financial reporting problems persist in SMAG's accounting and budgeting reports, where we identified billions of dollars of unexplained differences in the reported net operating results each year from fiscal years 1992 through 1996. Because SMAG's financial reports cannot be relied upon, DOD cannot be certain (1) of the actual operating results for SMAG or (2) whether the prices SMAG charges its customers are reasonable.

In recognizing the funds' financial reporting problems and other inefficiencies in fund operations, the National Defense Authorization Act for Fiscal Year 1997 required DOD to develop an improvement plan by September 30, 1997. In response to this requirement, DOD acknowledged that the working capital funds have financial reporting problems and arrived at decisions to address them. It has not yet though developed a detailed implementation plan that lays out the specific steps that need to be taken to correct the problems.

Working Capital Funds Need Accurate Financial Reports to Manage Operations

Having accurate financial reporting information is essential to monitoring fund operations, preparing budgets, and setting proper prices. For example, without accurate financial reports on SMAG, DOD and Air Force managers cannot effectively

- analyze trends, such as annual or monthly increases or decreases in billings to and reimbursements from customers to reduce or eliminate the need for additional working capital;
- perform monthly aging analysis of accounts receivable to identify old outstanding transactions; and
- measure the progress of execution data against the original budget, such as monitoring estimated and actual collection and disbursement amounts to assess operational and financial problems.

Volume 1 of the Department of Defense Financial Management Regulation recognizes that DOD accounting systems should provide critical data for use in budget formulation and monitoring budget execution. Thus, it requires that financial management data be recorded and reported in the same manner throughout DOD components and that accounting information be synchronized with budgeting information.

Persistent Financial Reporting Problems in the Working Capital Funds

As mentioned earlier, we have previously reported[1] that DOD has had long-standing problems in preparing accurate working capital fund financial reports, particularly with regard to the accuracy of the net operating results. For example, in March 1993, we reported that although SMAG's fiscal year-end 1992 financial report—as prepared by DFAS—showed a loss of $8.6 billion, an Air Force analysis disclosed a profit of $800 million. The $9.4 billion difference exceeded SMAG's total revenue reported by DFAS for that year. Similarly, in March 1994, we reported that the Navy supply management activity group's monthly financial report for May 1993 showed a profit of $23.1 billion which was over five times greater than the $4.3 billion in reported revenue for the same month and, therefore, was in error. We reported in March 1995, that due to a $6 billion clerical error, the Army supply management activity group reported an operating loss of $8.5 billion for fiscal year 1994 on a program that reported revenue of $7 billion for the same period. In addition, the DOD Inspector General has not been able to express an opinion on the accuracy of the Defense Business Operations Fund[2] financial statements for fiscal years 1993 through 1996 due to significant deficiencies in the accounting systems and the lack of sound internal control structure.

DOD has frequently acknowledged that the working capital funds' financial reports are inaccurate—in the Acting Comptroller's February 2, 1993, letter to the congressional defense committees; in the Defense Business Operations Fund September 24, 1993, improvement plan; and in DOD's February 2, 1994, response to our October 1993 letter on the Defense Business Operations Fund improvement plan.

[1]Defense Business Operations Fund: Management Issues Challenge Fund Implementation (GAO/AIMD-95-79, March 1, 1995); Defense Business Operations Fund: Improved Pricing Practices and Financial Reports Are Needed to Set Accurate Prices (GAO/AIMD-94-132, June 22, 1994); Financial Management: Status of the Defense Business Operations Fund (GAO/AIMD-94-80, March 9, 1994); and Letter to Congressional Committees on the Defense Business Operations Fund (GAO/AFMD-93-52R, March 1, 1993).

[2]The Defense Business Operations Fund is now called the Army, Navy, Air Force, and Defense-wide Working Capital Funds.

More recently, DOD reported in its fiscal years 1996 and 1997 Annual Statement of Assurance as required by the Federal Managers' Financial Integrity Act that inadequate accounting and reporting for the working capital funds, including the Air Force SMAG, were major control deficiencies. The Air Force also recognized SMAG financial reporting as a material weakness in its fiscal year 1997 Statement of Assurance. In this statement, the Air Force reported weaknesses in inventory valuation and noted the adverse effect it has on forecasting budget requirements. It stated that correcting this problem will result in more accurate inventory pricing and budgets. The Air Force also reported that internal controls were not sufficient to ensure that SMAG accounts were accurately reflected in financial statements.

DOD has stated in the past that it was acting to correct these financial reporting problems. For example, in the Defense Business Operations Fund improvement plan dated September 1993, DOD stated that the primary causes of the financial reporting problems were (1) inconsistent or insufficient policy guidance and (2) inadequate financial systems. DOD's September 1993 plan identified numerous actions needed to correct the deficiencies identified with the guidance and financial systems.

However, because these long-standing problems continued, the congressional Defense committees acted to mandate improvements in the financial operations of the working capital funds. Specifically, the National Defense Authorization Act for Fiscal Year 1997 required DOD to prepare a plan by September 30, 1997, to improve the management and performance of the working capital funds. Among other things, the Act required DOD to address the issue involving financial reporting requirements.

In response to the authorization act requirement, DOD developed a plan to improve the management and performance of its working capital funds. In this plan, dated September 1997, DOD stated that the working capital funds have financial reporting problems and DOD recognized that (1) differences between the budgeting and accounting reports for the same information confuses managers and should be eliminated, (2) large adjustments significantly affecting the operating results can occur as long as 4 months after the "as of" date and undermine management's confidence in the reports, (3) a formal reconciliation of the various reports is not presently performed, and (4) eliminating the differences—or providing a reconciliation—would make reports more useful to decisionmakers and restore creditability and confidence in the reports.

DOD's plan also identifies decisions made to correct these financial reporting problems which include (1) developing policies and procedures for reconciling budgetary and accounting reports, (2) developing a handbook that identifies the differences between the various reports to assist managers in monthly report analysis, and (3) revising the cost of goods sold treatment and presentation in the 1307 accounting report.

The DOD September 1997 plan does a good job in identifying the problems hindering accurate financial reporting and the decisions reached to resolve the problems. However, DOD does not yet have an implementation plan that identifies (1) the specific tasks that need to be accomplished, (2) individual DOD component's responsibilities when two or more components are involved with correcting the problem, or (3) milestones that could provide a basis for monitoring progress. DFAS officials told us that they are developing the detailed tasks that need to be performed.

SMAG's Financial Reports Are Unreliable and Inconsistent

Financial reporting weaknesses still persist in SMAG's accounting and budgeting reports. Our comparison of SMAG's accounting and budgeting reports for fiscal years 1992 through 1996 identified billions of dollars of differences in the reported net operating results and cost of goods sold—two factors that are integral in developing prices to be charged customers. Without reliable financial reports, DOD cannot be certain if SMAG's prices will recover the costs of providing inventory to its customers. Moreover, the Congress, DOD, and the Air Force will not have the information they need for oversight and decision-making purposes.

SMAG's Accounting Reports and Chief Financial Officer Reports Are Inconsistent

We compared SMAG's net operating results reported in its Chief Financial Officer reports (the working capital fund's annual financial statement) and in its 1307 accounting reports (the fund's monthly accounting report which provides data on fund operations, including revenue earned, expenses incurred, profits, and losses) for fiscal years 1992 through 1996 and identified annual differences totaling billions of dollars. For the 3 most recent fiscal years, these differences are detailed in table 2.1. Both of these reports provide budget execution data on SMAG and, therefore, should provide the same information.

Table 2.1: SMAG's Reported Net Operating Results for Fiscal Years 1994 Through 1996

(Dollars in millions)

Fiscal year	CFO report	1307 report	Difference
1994	$ (119.4)	$3,355.0	$3,474.4
1995	(12,873.1)	(4,642.9)	8,230.2
1996	2,162.6	(2,022.2)[a]	4,184.8

[a]This is the original 1307 accounting report issued in November 1996. This report was revised in April 1997 so that the figures contained in this report and the CFO report would match.

As indicated in the above table, for fiscal year 1996, the original fiscal year-end 1307 accounting report, issued in November 1996, showed that SMAG had a net operating loss of about $2 billion. After this report was issued, DFAS made four revisions in preparing the SMAG portion of the Chief Financial Officer report, which had a major impact on SMAG's net operating results. Specifically, DFAS adjusted the net operating results to show

- a positive $459 million in versions one and two of the Chief Financial Officer report,
- a negative $11 billion in version three, and
- a positive $2.2 billion balance in version four—the final Chief Financial Officer report.

After these changes were made, DFAS revised the original 1307 so that the amounts in that report would match the amounts in the CFO report. The size of these changes is significant, especially considering the fact that SMAG's total revenue was $12.8 billion, according to the Chief Financial Officer report.

The Air Force Has Not Reconciled the Net Operating Result Differences in the Accounting Report and the Budget Justification Report

We also compared SMAG's reported net operating results in the 1307 accounting report to the Air Force Working Capital Fund budget justification report—which provides reported actual and budgetary data on revenue, expenses, net operating results, and prices and is also essential to managing SMAG operations. Again, we identified significant differences totaling billions of dollars for fiscal years 1992 through 1996. For example, the 1307 accounting report showed that SMAG lost about $2 billion during fiscal year 1996 while the budget report showed that it lost $99 million.

Differences between these two reports are expected since not all the accounts used to determine the net operating results in the 1307

accounting report are used to develop the net operating results in the budget. For example, if Air Force disposes of inventory items and does not plan to replace these items, it does not consider this an expense for budgeting purposes. However, for accounting purposes, this is considered an expense that reduces the net operating results. The Department of Defense Financial Management Regulation (DOD 7000.14-R) requires business activities to (1) explain the differences between the net operating results shown in the 1307 accounting report and those used in the budget formulation of prices charged customers as shown in the budget, (2) identify and justify the net operating result amounts in the 1307 accounting report that DOD components request be excluded from the prices, and (3) obtain approval from the Office of the Under Secretary of Defense (Comptroller) for the amounts to be excluded. The Air Force did not reconcile the net operating results shown in these two reports as required because it believed that the 1307 accounting report was incorrect.

Given the magnitude of the net operating result differences reported in the 1307 accounting report, Chief Financial Officer report, and the budget, it is clear that the figures contained in these reports cannot be relied upon for oversight and decision-making. Without knowing the net operating results, the Air Force cannot determine whether the prices being charged SMAG's customers will allow it to recover its costs and operate on a break-even basis. In some cases, the prices might have been set too high because of erroneous net operating result data. In other cases, prices might have been set too low to recover the costs of providing goods and services, thereby resulting in a cash shortage. (See chapter 3 for a discussion of SMAG pricing problems and chapter 4 for a discussion of cash problems.)

SMAG Cannot Determine an Accurate Cost of Goods Sold Amount

A root cause of SMAG's inability to accurately report on its financial operations is that it cannot determine an accurate cost of goods sold. The cost of goods sold is an important factor used in arriving at the group's annual net operating results (revenue less expenses, which include the cost of goods sold, equals net operating results). Our comparison of SMAG's cost of goods sold reported in its Chief Financial Officer reports, 1307 accounting reports, and budget justification reports for fiscal years 1992 through 1996 identified differences totaling billions of dollars. These differences are detailed in table 2.2.

Table 2.2: SMAG's Reported Cost of Goods Sold for Fiscal Years 1992 Through 1996

(Dollars in millions)

Fiscal year	CFO report	1307 report	Budget report
1992	$8,745	$8,909	$7,719
1993	7,743	8,754	7,656
1994	9,889	7,476	8,313
1995	15,901	7,132	8,935
1996	10,929	10,390	8,204

Office of the Under Secretary of Defense (Comptroller) and/or DFAS officials told us that DOD's logistical and accounting systems are not capable of providing the necessary information to identify the actual (historical) cost of goods sold amount based on normal commercial practices such as the first-in, first-out cost or weighted average cost of the items sold. Therefore, DOD uses the latest acquisition cost method to value inventory and arrive at the cost of goods sold which is permissible under the Statement of Federal Financial Accounting Standards No. 3, Inventory and Related Property.

DOD uses a summary-level formula to adjust the value of inventory from the standard (selling) price to the latest acquisition cost by removing surcharges for operating costs from the standard price. Once DOD determines the latest acquisition cost, it then uses the following general formula for computing the cost of goods sold:

Beginning inventory at beginning-of-the-period latest acquisition cost[3]
Less: Beginning allowance for unrealized holding gains/losses
Plus: Purchases of goods for sale
Less: Disposal or other drawdown of goods other than sale
Equals: Cost of goods available for sale
Less: Ending inventory at end-of-the-period latest acquisition cost
Plus: Ending allowance for unrealized holding gains/losses
Equals: Cost of goods sold

However, as evidenced by the reported differences shown in table 2.2, DOD has had problems implementing this formula to compute the cost of goods sold. Office of the Under Secretary of Defense (Comptroller) and DFAS

[3]Since the latest acquisition cost method provides that the latest invoice price (price SMAG paid to acquire the item from a vendor) be used to value all like inventory items regardless of the amount paid for the items, the inventory needs to be revalued to reflect unrealized holding gains and losses to arrive at an approximation of the historical (actual) value of the inventory. The amount of unrealized gain or loss is the difference between the recorded value of the inventory and the actual cost to acquire the inventory.

officials also told us that in order to determine the actual (historical) cost of the goods sold, the method for valuing inventory must be changed from the current method of using the latest acquisition cost to valuing inventory based on historical costs. If DOD changes its method for valuing inventory, it must ensure that its method complies with the Statement of Federal Financial Accounting Standards No. 3.

These officials further stated that by valuing inventory at historical cost, DOD would know the cost of each individual item sold, something it does not know now. This information could then be summarized for reporting on the supply management activity groups' financial operations in DOD's monthly accounting reports. However, the officials stated that before inventory could be valued at historical cost, DOD would have to either (1) modify its existing logistical and accounting systems or (2) develop new ones. Either option would be a long-term effort.

Conclusions

SMAG's financial reports cannot be relied upon to provide DOD and Air Force management or the Congress reliable information on SMAG's results of operations. DOD has discussed this financial reporting problem in its September 1997 plan on improving the working capital funds and has identified several actions to correct the problem. However, it has not yet developed a detailed implementation plan to help ensure that the problems are corrected. Until SMAG can (1) determine its cost of goods sold and (2) reconcile the net operating results reported in the 1307 report to the net operating results reported for budgeting purposes, SMAG's financial reports will continue to be questioned and lack credibility, and it will be extremely difficult, or impossible, to determine if the prices charged customers reflect what they need to be in order to recover costs.

Recommendations

To ensure that DOD acts to correct SMAG's financial reporting problems and develop an accurate cost-of-goods sold figure, we recommend that the Secretary of Defense develop a detailed implementation plan to ensure that the actions identified by DOD in September 1997 to correct the financial reporting problems are carried out promptly. The plan should (1) identify specific actions that need to be taken including the modification of existing systems or development of new systems, (2) establish milestones, (3) clearly delineate responsibilities for performing the tasks in the plan, and (4) ensure compliance with accounting standards on accounting for inventory and related property.

To help link information contained in the accounting report to budget formulation, we also recommend that the Secretary of the Air Force direct a reconciliation of the net operating results in the 1307 accounting report to the reported actual net operating results in the budget justification report that is used for budgeting purposes.

Agency Comments

In its written comments, DOD concurred with our recommendation to develop a detailed implementation plan to ensure that the actions identified by DOD in September 1997 to correct the financial reporting problems are carried out in a timely manner. DOD has established three working groups that will develop specific implementation and execution plans and procedures for financial reporting. These three groups will meet throughout the summer of 1998 with reports expected later this year.

DOD also concurred with our recommendation to reconcile the net operating results in the 1307 accounting report to the reported actual net operating results in the budget justification report that is used for budgeting purposes. DOD stated that additional lines have been added to the Working Capital Fund 1307 accounting reports to help explain the net operating differences that are reflected in the two reports.

Difficulties Encountered in Developing Prices

DOD policy requires the military services to develop prices for the working capital funds and use these prices as a basis for determining customer funding requirements. The baseline for this process should be the cost of buying and/or repairing items that are sold—which is known as the cost of goods sold. The Air Force, however, does not have reasonably reliable estimates of the number and type of items that SMAG customers will need or the expected cost of buying and/or repairing these items. Since it cannot use the cost of goods sold as the basis for SMAG's prices, the Air Force has had to resort to using two separate processes to develop prices. The first process is used to develop a composite, or aggregate, price change in terms of percentage from one fiscal year to the next. This price change is then used to develop customers funding levels. The second process is used to establish prices for individual inventory items that reflect the expected cost of providing these items to customers.

Ideally, these two processes would ensure that customers will have sufficient funds to buy the items they need. However, this objective is not always accomplished for the following two reasons. First, there are no checks to ensure that the composite price changes approved by the Under Secretary of Defense (Comptroller) are implemented. Second, problems with the implementation of new procedures for allocating operating cost to individual inventory items could result in some customers receiving either too much or too little funding in fiscal year 1998, and have left Air Force officials without the reliable historical and/or budget execution data they need to effectively reallocate funds.

Two Separate Processes Used to Develop Customers' Funding Levels and Prices for Individual Items

The two primary objectives of SMAG's price-setting process are to ensure that (1) prices charged for individual items reflect the expected cost of providing these items to customers and (2) SMAG's composite, or aggregate, price change is identified—so that it can be properly factored into customer budgets. Because it lacks reliable data on SMAG's cost of goods sold (see chapter 2) and reasonable estimates of customers' needs,[1] the Air Force cannot accomplish these objectives through the traditional approach—developing prices for individual items and then applying these prices to estimates of customer needs as the basis for determining customer funding requirements. As a result, it uses a summary-level analysis to establish a composite price change for SMAG customers and, in turn, customer funding levels, and then attempts to establish prices for individual items that are consistent with the composite price change.

[1]SMAG officials acknowledge that it can provide only "ballpark" estimates of customer requirements, in part, because customer funding levels are developed between 9 and 15 months before the start of the fiscal year when they go into effect.

Customer Funding Levels Are Based on Historical Data and Expected Changes

During the annual budget review process, the Air Force develops an estimate of customer funding requirements that is subsequently approved by the Office of the Under Secretary of Defense (Comptroller). This estimate is based on factors such as (1) what customers have spent on inventory purchases in the past, (2) anticipated changes in requirements, such as planned deactivations of units, and (3) expected changes in SMAG's costs, such as the anticipated effect of planned cost reduction actions. For example, during fiscal years 1997 through 1999, using this estimating process, SMAG's prices and its customers' funding levels were reduced by about $950 million to reflect the savings the Air Force expects to achieve from its Lean Logistics initiative.[2]

During the annual budget review process, Air Force headquarters also develops, and the Office of the Under Secretary of Defense (Comptroller) approves, a composite, or aggregate, price change that represents the average percentage price increase or decrease that SMAG customers will experience during the budget year. As shown in table 3.1, from fiscal years 1992 through 1998, SMAG's authorized composite price change ranged from a 26.7 percent increase to a 26.2 percent decrease.

Table 3.1: SMAG's Authorized Composite Price Changes for Fiscal Years 1992 Through 1998

Fiscal year	Percent of composite price change
1992	(26.2)
1993	20.7
1994	26.7
1995	(9.9)
1996	(16.5)
1997	(1.2)
1998	19.3

Source: DOD budget documents.

Actual Prices Are Based on Latest Acquisition Costs or Latest Repair Costs Plus Surcharges

To ensure that SMAG and other working capital fund activities operate on a break-even basis over time, DOD policy requires that prices be (1) based on expected costs and (2) adjusted to return prior year profits to customers or recoup prior year losses from them. It also requires that the prices be established at the beginning of the fiscal year and remain constant throughout the year.

[2]This initiative is expected to reduce the amount of time required to satisfy customers' requests and, in turn, to reduce the number of items that SMAG must buy or repair.

Prices that customers actually pay for SMAG's individual inventory items are determined by adding a surcharge to each item's latest acquisition cost or latest repair cost. Specifically, "standard" prices are determined by adding surcharges to the latest acquisition costs, and "exchange" prices are determined by adding surcharges to the latest repair costs. SMAG charges exchange prices when customers turn in broken repairable items and receive serviceable items in return. It charges standard prices for all nonrepairable items and for repairable items if customers do not turn in broken items.

The surcharges that are added to the price of each inventory item are expected to cover SMAG's operational costs for such things as salaries, inventory storage, and accounting and automated data processing services. They also cover other factors, such as (1) reductions to reflect the anticipated effect of cost reduction initiatives and (2) returning profits or recouping prior year losses. Between fiscal years 1994 and 1998, these surcharges ranged from a low of $1.0 billion to a high of $2.1 billion and accounted for between 30 and 50 percent of SMAG's expected wholesale revenue.

Pricing Procedures Do Not Ensure That Approved Price Changes Are Properly Implemented

It is important that the prices established for individual items be consistent with the composite price change approved by the Under Secretary of Defense (Comptroller) and used in budgeting. If actual prices are set lower than the approved level, then customers may have more funds than they need and scarce resources may be wasted. Conversely, if actual prices are set higher than the approved level, then customers may not have enough funds to buy the items they need.

However, the Air Force does not have effective procedures to ensure that the actual prices are, in fact, consistent with the composite price change that has been approved by the Under Secretary of Defense (Comptroller). It generally does not know that there is a problem with SMAG's prices until and unless the problem is reflected in budget execution data. For example, SMAG's fiscal year 1997 prices were reduced by about 18 percent, effective April 1, 1997, when budget execution data showed that customers were spending much more than expected for inventory items, and Air Force officials determined that customers did not have sufficient funds to last the remainder of the fiscal year.

According to Air Force headquarters officials, this problem occurred because (1) SMAG had to pay more than budgeted for the repair of items

and (2) when these higher-than-expected costs were incorporated into SMAG's prices, it caused SMAG's composite price increase to be higher than the one approved by the Office of the Under Secretary of Defense (Comptroller) during the budget review process. Reducing SMAG's prices without reducing its cost adversely affected SMAG's net operating results and the Air Force Working Capital Fund's cash balance.

The Air Force has recognized that it needs to take additional steps in the price-setting process. Specifically, after the prices for individual items are established and before the start of the fiscal year, the Air Force believes, and we agree, that it should (1) determine if the new prices, when applied to the best available estimate of customer orders, will result in the approved composite price change and (2) adjust the prices for individual inventory items, if necessary. AFMC officials acknowledged the need for corrective action such as this and indicated that they plan to take it.

New Cost Allocation Procedures and Data Problems Have Created Customer Budgeting Problems

New procedures for allocating SMAG's operational costs to individual inventory items (calculating surcharges), combined with data reliability problems, have resulted in fiscal year 1998 price changes that have varied significantly not only from one inventory item to the next but also from one month to the next. As a result, the Air Force's initial allocation of funding to SMAG customers left some with either too much or too little funding. Further, although Air Force headquarters can and has alleviated this problem by reallocating available funds, it lacks the reliable historical and budget execution data it needs in order to properly do so now and in the future.

Goal of New Procedures Is to More Accurately Allocate Costs

As discussed above, prior to fiscal year 1998, SMAG recouped its expected operational costs by applying a standard surcharge percentage to all wholesale items. The advantage of this approach is that it does not require reliable data on an individual supply activity's operational costs or projected revenue—because all operational costs are aggregated and then allocated uniformly to all items at all supply activities. The disadvantage is that, under this approach, the operations of inefficient supply activities are, in essence, subsidized by more efficient activities. This, in turn, makes it difficult to identify inefficient operations and activities, and causes many customers to pay either more or less than they should for their inventory purchases. For example, if one ALC's overhead costs were higher than the other four ALCs', some of its overhead costs would be included in the

prices charged by the other four ALCs even though they may operate more efficiently.

On October 1, 1997, the Air Force made two major changes in SMAG's cost allocation procedures in order to better match costs with the prices customers were being charged. First, under the new cost allocation procedures, SMAG will, where possible, identify the estimated costs associated with individual supply activities—the five ALCs—and allocate each ALC's costs to only those items that it manages. Second, the estimated cost of procuring inventory items to replace repairable items that can no longer be repaired economically (condemned items) will be recouped by adding a surcharge to the cost of the item being replaced rather than by adding a standard surcharge to all repairable items, which was the previous practice.

Air Force headquarters officials stated that the implementation of the new cost allocation procedures has led to increased awareness of costs and increased emphasis on accurately estimating both costs and sales revenue. For example, they told us that because SMAG's operational costs are now allocated, where possible, directly to the individual ALCs that incur them, the ALCs are now much more aware of and concerned about these costs. Similarly, they noted that, because the ALCs' overhead cost allocations and surcharge percentages are based largely on their projected sales revenues, there is also increased emphasis on accurately projecting individual ALC's sales revenue.

SMAG Lacks Data Needed to Effectively Implement Its New Cost Allocation Procedures

To effectively implement the new cost allocation procedures, SMAG needs reliable sales revenue and operational cost data for individual ALCs. However, it has neither—in part because it did not begin accumulating actual sales data for individual ALCs until fiscal year 1997. As a result, SMAG's initial fiscal year 1998 prices, which became effective on October 1, 1997, were based on unreliable sales and operating cost data and, therefore, had to be revised, effective November 1. In addition, because some of the November 1, 1997 price changes were not processed properly by the ALCs' automated systems, another price change had to be implemented for many items, effective December 1, 1997.

Each of these price changes was based on a reallocation of sales revenue and/or operational costs among the five ALCs and was associated with a major change in the size of the surcharges added to individual items. For example, the surcharges used to establish exchange prices for Sacramento

ALC-managed items ranged from a low of about 46.6 percent to a high of 287.1 percent.

Table 3.2 shows how these changes affected the price of individual items. For example, customers paid $8,859 for an alternating generator on October 1. On November 1, customers paid $23,391—about 2.6 times as much as the price on October 1. On December 1, they paid $16,727.

Table 3.2: Examples of Fiscal Year 1998 Price Changes for Sacramento ALC-Managed Items

		Price			
Item description	Type price	Fiscal year 1997	October 1997	November 1997	December 1997
Klystron tube	Exchange	$114,326	$147,750	$279,001	$279,001
Traveling wave tube	Exchange	$ 74,273	$200,190	$200,190	$179,849
Alternating generator	Exchange	$ 7,307	$ 8,859	$ 23,391	$ 16,727
Load coil	Standard	$ 5,838	$ 7,104	$ 10,623	$ 11,059
Extractor tool	Standard	$ 570	$ 5,570	$ 8,093	$ 8,676

These large price changes distort SMAG customers' budget execution data for fiscal year 1998 and make it difficult for the customers and those providing oversight over their operations to determine if an appropriate level of funding has been provided.

New Cost Allocation Procedures Have Created Customer Budgeting Problems

Although SMAG's December 1, 1997, price change resulted in surcharges of at least 25 percent for all items at all ALCs, the surcharges are especially high for Sacramento ALC-managed items. This is primarily because Sacramento, which is scheduled to close in July 2001, has a much lower sales volume than the other ALCs and therefore, must spread its operational costs over a smaller base. As shown in table 3.3, the surcharges added to Sacramento's standard prices (132.3 percent) and exchange prices (176.8 percent) are at least three times higher than those of the other ALCs.

Table 3.3: SMAG Surcharges[a] for Five ALCs as of December 1, 1997

ALC	Standard price surcharge	Exchange price surcharge
Oklahoma City	26.5%	45.0%
Ogden	36.9%	45.0%
San Antonio	26.0%	40.4%
Sacramento	132.3%	176.8%
Warner Robins	26.1%	32.4%

[a]Standard surcharges are expressed as a percent of the latest acquisition cost, while exchange surcharges are expressed as a percent of the latest repair cost.

Because the ALCs used a standard surcharge in fiscal year 1997, Sacramento's substantially higher fiscal year 1998 surcharges will cause price increases for its items to be much higher than the SMAG average. As a result, customers that rely heavily on the Sacramento ALC for their support, such as those that operate communications-electronics and space systems, are the ones that are most likely to have received insufficient funding. For example, the Air Force Space Command used more than half of its fiscal year 1998 spares funding during the first quarter of the year, and Space Command officials believe that their units will be unable to acquire the parts they need unless Air Force headquarters provides additional funds or they can transfer funds from another program.

Customers that purchase inventory from the other ALCs also expressed concern. For example, officials of the Air Combat Command—which purchases inventory items from all the ALCs—stated that the implementation of the new cost allocation procedures have caused them "tremendous concern." They acknowledged that the numerous pricing changes that occurred during fiscal year 1998 make it virtually impossible for them to determine whether they will have sufficient funding to cover their needs during fiscal year 1998. However, their analysis shows that they expect to experience funding shortages in most of their major weapons systems in fiscal year 1998 if additional funds are not provided.

Because (1) SMAG's new procedures for allocating operating cost to individual inventory items significantly impacted the fiscal year 1998 prices charged customers for individual items and (2) the overall impact varied significantly from one customer to the next, the Air Force does not have historical data on the amount of money needed by individual customers to purchase inventory. Air Force budget officials told us that it would take at least 1 to 2 years, perhaps even more, of actual experience to have sufficient data to reliably estimate individual customer needs. As a result, although the Air Force has already adjusted customer funding levels once, these officials acknowledged that they will have to continue to monitor budget execution data and to make further adjustments if necessary.

Conclusions

To develop prices that will enable SMAG to operate on a break-even basis, the Air Force needs reliable information on (1) SMAG's expected cost of goods sold and on (2) the expected sales revenue and operational costs of the individual ALCs. However, the Air Force does not have this reliable information. It also does not have adequate procedures to ensure that

customers receive sufficient funds to purchase required inventory items and, as a result, had to reduce SMAG's prices half way through fiscal year 1997 so that customers would not run out of money. Compounding this problem are the new cost allocation procedures and the implementation of those procedures which resulted in three different sets of prices so far during fiscal year 1998. This has caused substantial price fluctuations during fiscal year 1998 that may cause customers to either purchase fewer inventory items than they planned or transfer funds from other accounts.

Recommendations

As recommended in the previous chapter, the Air Force needs to develop an effective process for determining the cost of goods sold. In addition, we recommend that the Secretary of the Air Force

- assess the impact of price changes to determine whether customers can acquire the goods they need in fiscal year 1998 and take funding reallocation actions, as appropriate, to meet the highest priority needs; and
- direct the AFMC Commander to develop and implement procedures to ensure that the prices that are established for individual inventory items are consistent with the composite prices developed and approved by the Office of the Under Secretary of Defense (Comptroller) during the budget process.

Agency Comments

In commenting on this report, DOD concurred with our recommendation to assess the impact of price changes to determine whether customers can acquire the goods they need in fiscal year 1998 and take funding reallocation actions as appropriate. The Air Force has already begun the process of reallocating resources to customers to ensure program integrity (vital functions can be performed). DOD also concurred with our recommendation to develop and implement procedures to ensure that the prices that are established for individual inventory items are consistent with the composite prices developed and approved by the Office of the Under Secretary of Defense (Comptroller).

Air Force Working Capital Fund and SMAG Cash Management Problems

The Air Force maintains one cash balance at the overall Air Force Working Capital Fund level and manages the fund's cash at that level. To ensure that the fund maintains an adequate level of cash to pay its bills, it is essential that managers (1) accurately project cash collections and disbursements and (2) actively monitor the fund's cash position by performing such analyses as comparing budget estimates for collections and disbursements to actual collections and disbursements and determining the reasons for the variances. DOD policy requires that if the level of cash becomes low and there is a possibility of incurring an Antideficiency Act[1] violation, immediate actions be taken to resolve the cash shortage by advance billing customers for work not yet performed.

Since June 1993, the Army, Navy, and Air Force Working Capital Funds, have experienced cash shortages and have advance billed customers for work not yet performed to ensure that sufficient funds were available to meet day-to-day operating expenses. DOD initially expected the working capital funds to eliminate advance billing in fiscal year 1995. However, the Air Force Working Capital Fund has not achieved this goal and has continued the practice of advance billing customers.

Since SMAG is the largest activity group in the Air Force Working Capital Fund, it is critical that SMAG properly manage its collections and disbursements. However, we found that SMAG did not accurately project cash (1) collections from sales and (2) disbursements for inventory items purchased from vendors. Further, SMAG was not adequately monitoring account receivable balances and outlay rates, which would have enabled it to identify the problem of inaccurately projecting collections and disbursements so that corrective actions could be taken to resolve the problem.

The Importance of Cash for Working Capital Funds

Cash generated from the sale of goods and services is the primary means by which the working capital funds activities pay their bills. The position where the cash balances start each year depends on the outcome of many decisions made during the budget process with regard to (1) projecting the volume of inventory items that will be sold, (2) estimating costs, and (3) setting prices to recover the estimated full cost of the goods and services. During the execution of the budget, the working capital funds operate much like a checking account: collections increase the fund's cash balance, and disbursements (such as salaries and purchases of inventory)

[1] The Antideficiency Act, 31 U.S.C. 1341(a)(1) provides that no officer or employee of the government shall make or authorize an expenditure or obligation exceeding the amount of an appropriation of funds available for the expenditure or obligation.

reduce the cash balance. To the extent that the decisions, such as cost reduction initiatives, made during the budget process are reasonably accurate, the funds' cash balances should fall between the minimum and maximum amount required by DOD. However, if the decisions are not accurate, the funds could have too much or not enough cash.

According to DOD's Financial Management Regulation, Volume 11B, the working capital funds are to maintain the minimum cash balance necessary to meet both operational requirements and to meet disbursement requirements in support of the capital asset program. In essence, the funds are to maintain a minimum cash balance which, at the same time, is sufficient to cover expenses, such as paying employees for repairing aircraft and vendors for inventory items. DOD's policy further requires the funds to maintain cash levels to cover 7 to 10 days of operational costs and 4 to 6 months of capital asset disbursements. To comply with DOD's policy, the Air Force Working Capital Fund should maintain a cash balance between about $465 million and $670 million. If the Air Force Working Capital Fund's level of cash drops below the minimum required balance and there is a possibility of incurring an Antideficiency Act violation, actions will be taken to resolve the cash shortage by advance billing customers.

Within the working capital fund there are three major activity groups—depot maintenance, supply management, and information services—whose operations significantly impact the fund's cash balance.[2] Of these activity groups, SMAG is the largest with 65 percent, or about $8.8 billion in reported disbursements out of the total $13.5 billion in reported disbursement made by the Air Force Working Capital Fund in fiscal year 1997.

Air Force Working Capital Fund Is Still Advance Billing Customers

We have previously reported[3] that the Defense Working Capital Funds have had a long-standing cash management problem including the practice of advance billing customers. Since 1993, the working capital funds have advance billed customers because they have not been able to generate enough cash to pay their bills. When the responsibility for managing cash

[2]Beginning in fiscal year 1998, the United States Transportation Command's transportation activity group was transferred from the Defense Working Capital Fund to the Air Force Working Capital Fund.

[3]Defense Working Capital Funds: DOD Faces Continued Challenges in Eliminating Advance Billing GAO/T-AIMD/NSIAD-97-221, July 22, 1997; Defense Business Operations Fund: DOD is Experiencing Difficulty in Managing the Fund's Cash (GAO/AIMD-96-54, April 10, 1996; Defense Business Operations Fund: Management Issues Challenge Fund Implementation (GAO/AIMD-95-79, March 1, 1995); and Financial Management: Status of the Defense Business Operations Fund (GAO/AIMD-94-80, March 9, 1994).

was returned to the military services and DOD components in February 1995,[4] the Air Force (as well as the Army and Navy) continued to advance bill customers so that its cash portion of the Defense Business Operations Fund would not have a negative balance.

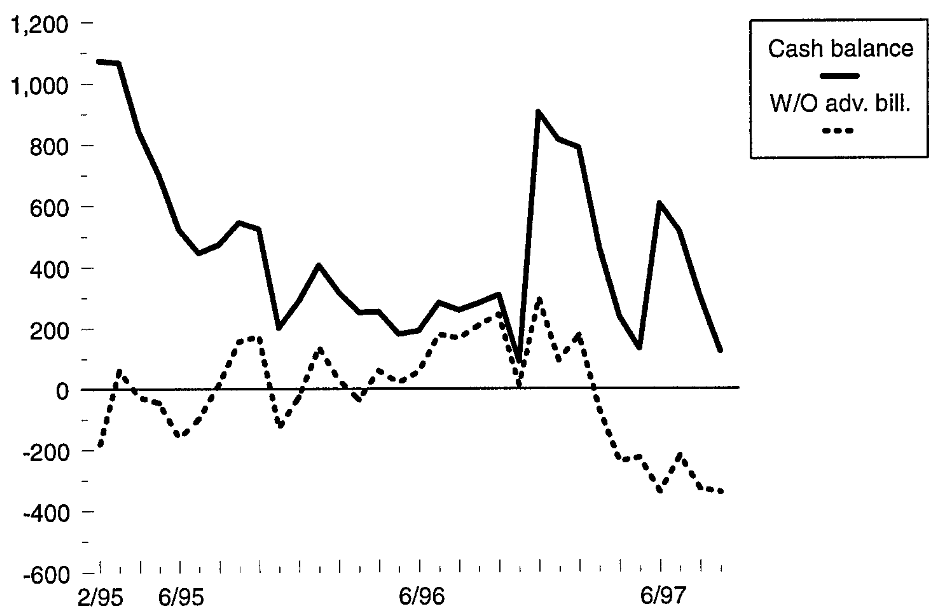
According to DOD budget documents, DOD anticipated that the working capital funds, including the Air Force Working Capital Fund, would be able to generate enough cash to eliminate advance billing in fiscal year 1995. This was to be achieved by (1) not replacing sold inventory on a one-for-one basis, (2) reducing costs, and (3) increasing prices for various reasons, such as to recoup prior year losses. When the fund failed to generate this cash, subsequent DOD budgets provided for an end to advance billing in fiscal year 1996, and again in fiscal year 1997. We found, however, that the Air Force Working Capital Fund did not achieve DOD's goal of eliminating the routine practice of advance billing customers.

The Air Force steadily reduced the Working Capital Fund's outstanding advance billing balance from about $1.3 billion in February 1995 to $77 million in November 1996. At the same time, the Fund's cash balance declined from $1.1 billion to $90 million. To ensure that its cash balance would remain positive, the Air Force Working Capital Fund advance billed customers over $1 billion in December 1996 and about $700 million in the June/July 1997 period. As of fiscal year end 1997, the Air Force Working Capital Fund's reported outstanding advance billing balance was $464 million. Air Force officials told us that they now plan to eliminate the outstanding advance billing balance by the end of fiscal year 1999.

The following figure shows the (1) reported cash balance for the Air Force Working Capital Fund and (2) cash balance if the Air Force Working Capital Fund had not advance billed its customers from February 1995 through September 1997.

[4]When the Defense Business Operations Fund was established, the responsibility for managing cash was placed under the Office of the Secretary of Defense (Comptroller) level. On February 1, 1995, cash management and the related Antideficiency Act responsibilities were returned to the military services and DOD component level.

Figure 4.1: Air Force Working Capital Fund Reported Cash Balance (Dollars in millions)



Note: Cash policy requires about $465 million to $670 million.

Source: DOD. We did not independently verify this information.

The Air Force recognizes that it has a cash shortage problem and added surcharges to generate cash totaling (1) $200 million to SMAG's fiscal years 1998 and 1999 customers' prices and (2) $75 million to the Air Force Depot Maintenance Activity Group's fiscal years 1998 and 1999 prices. If these cash surcharges do not alleviate the problem, the Air Force may have to continue adding a surcharge to the prices to generate cash.

Further, to improve cash management in the Air Force Working Capital Fund, the Air Force held a meeting in February 1998. Attending the meeting were officials from the Office of the Secretary of the Air Force, AFMC, DFAS, and various ALCs. The Air Force developed specific action items for the Depot Maintenance, Information Services, and Supply Management Activity Groups. According to Air Force officials, accounting system enhancements should result in better forecasting which will help the Air Force reduce the need for additional cash surcharges and advance billings. A follow-up meeting to discuss progress is scheduled for November 1998.

SMAG's Cash Collection and Disbursement Projections Not Accurate

To facilitate the cash management process, DOD policy requires that the working capital funds develop cash plans which include estimated collection and disbursement data. Being able to accurately project collections and disbursements is critical to the working capital funds' ability to maintain an adequate level of cash to meet operational and capital requirements. DOD's cash management policy further requires that projected collections and disbursements be monitored during execution in order to assess operational and financial problems and take the necessary actions to correct the problems. However, we found that SMAG did not accurately project cash (1) collections from foreign military sales (FMS) and (2) disbursements to be made to vendors for inventory items. In addition, SMAG managers did not adequately monitor account balance data on FMS collections and vendor disbursements.

Our analysis of SMAG's cash plans and reports show that SMAG made a reported $237.3 million in cash from fiscal year 1992 through fiscal year 1997. Our analysis also shows that SMAG made $683.3 million less than projected in fiscal years 1996 and 1997. This is of particular concern since SMAG disbursed more money than it collected at the same time the Air Force Working Capital Fund was experiencing a cash shortage problem and was advance billing customers.

Estimated Cash From Foreign Military Sales Overstated

From fiscal year 1993 through fiscal year 1996, AFMC did not accurately project cash collections from FMS. AFMC erroneously estimated FMS revenue based on charging FMS customers the standard price (acquisition cost of the item plus surcharges) for depot level repairable inventory items rather than the exchange price (repair price of the item plus surcharges) that FMS customers actually paid. According to Air Force officials, AFMC budgeted FMS revenue and collections based on the standard price because it assumed that FMS customers would not be turning in broken inventory items (referred to as carcasses) in exchange for good, "useable" items. However, FMS customers turned in the carcasses. As a result, actual cash collections were about $429 million less than budgeted from fiscal year 1993 through fiscal year 1996.

The difference between the standard price and exchange price that the FMS customer paid was recorded in a receivable account called "other assets accounts receivable—deliveries suspense." As shown below, the amount steadily grew from fiscal year 1993 through fiscal year 1996.

Table 4.1: Dollar Amount Reported in Account Called Other Asset Accounts Receivable—Deliveries Suspense

(Dollars in millions)

Fiscal year	Amount
1993	$208.2
1994	298.0
1995	527.1
1996	776.8

Source: SMAG general ledger. We did not independently verify this information.

Because AFMC personnel were not adequately monitoring account balance information, they did not realize that FMS customers were turning in broken items until SMAG started to experience cash problems in early fiscal year 1996. This was soon after the Air Force received cash management responsibilities for the working capital fund. Until that time, AFMC managers were not monitoring the account's balances because, from an overall cash position, there were no adverse issues regarding SMAG's cash. AFMC has begun to resolve this problem. Beginning in fiscal year 1997, revenue from FMS customers was budgeted at the exchange price.

Cash Outlay Rates Not Accurately Projected

From a cash management standpoint, when SMAG orders inventory items from vendors, it is critical that the Air Force accurately project the timing of delivery since SMAG pays the vendors based on the delivery of the inventory items. The time period used for projecting outlays depends on the type of inventory items being purchased and can cover several years starting from the time the items are ordered from vendors. AFMC officials assumed that vendor deliveries, and thus cash outlays, would be greater in the earlier years of the delivery period and less in the later years. Accordingly, AFMC projected its cash outlays to fit this delivery pattern.

However, Air Force officials stated that AFMC's projected outlays have not materialized as expected. Cash outlays in the early years were significantly less than expected, while outlays in the later years were more than expected. According to Air Force supply management officials, until recently, outlay rates for the Reparable Support Division inventory buys were not being updated each year to better reflect vendor delivery patterns. The following table illustrates the shift in projected outlay rates over a 5-year outlay period. It also shows the (1) outlay rates that have been used over the past several years and (2) revised outlay rates—based on the Air Force's analysis of current outlay pattern—used in developing the Air Force's fiscal year 1999 budget estimate submission for SMAG.

Table 4.2: Reparable Support Division Original and Revised Projected Outlay Rates

Year of outlay	Original projected outlay rates (percent)	Revised projected outlay rates (percent)	Percentage change from original to revised
1st year	7.8	2.9	(62.8)
2nd year	24.9	17.0	(31.7)
3rd year	37.2	32.6	(12.4)
4th year	17.8	23.8	33.7
5th year	12.3	23.7	92.7

Source: Air Force projected outlay rate schedules.

AFMC managers did not realize that there was a problem with projected cash outlays until SMAG started to experience cash problems in early fiscal year 1996. According to AFMC officials, outlay rates were not monitored because there were no adverse issues regarding SMAG's cash.

AFMC officials told us that they do not have the basic information for projecting cash outlays, such as item managers' delivery projections or good, historical data by fiscal year on vendor contracts. DOD's September 1997 report[5] also acknowledged that managers do not have the necessary information nor an automated cash model to assist them in predicting required cash levels, forecasting cash positions, or for predicting end-of-period cash positions on a weekly, monthly, or annual basis.

AFMC officials acknowledged that they need better management tools for projecting cash outlays for all types of SMAG outlays. They noted that projecting outlay rates is relatively easy for obligations and disbursements that occur within the same year (such as paying salaries or accounting services provided by the DFAS). However, this process becomes much more complicated when it comes to disbursements that occur several years after the obligation (such as purchases of repairable inventory items from vendors), and thus there is a critical need for better information and tools that can guide fund managers. Recognizing this, AFMC contracted with a major public accounting firm to develop a cash forecasting model.

Conclusions

The Air Force Working Capital Fund depends on its activity groups to effectively manage their cash in order for the fund to have enough cash to pay for day-to-day operating expenses. However, the activity groups have

[5]The National Defense Authorization Act for Fiscal Year 1997 required DOD to prepare a report on improving the management and performance of the working capital funds.

not generated sufficient cash to eliminate the practice of advance billing customers. With regard to SMAG, this activity group has made less cash than estimated from fiscal year 1993 through fiscal year 1997. This problem will undoubtedly persist until SMAG (1) develops and uses management tools, such as cash forecasting models to project the amount of collections to be received and disbursements to be made in future years and (2) emphasizes the need to monitor account balances and takes steps needed to identify and correct the problems.

Recommendations

We recommend that the Secretary of the Air Force direct the Commander, Air Force Materiel Command to

- ensure that the development of the cash forecasting model includes the capabilities to forecast (1) required cash level, (2) end-of-period cash positions on a weekly, monthly, or annual basis, (3) disbursements to be made in future years based on when vendors are scheduled to deliver items to SMAG and the prices charged by the vendors, and (4) receipts based on SMAG's sales; and
- monitor accounts receivable balances and cash outlay rates to identify anomalies and their causes so that corrective actions can be taken.

Agency Comments

In its comments, DOD concurred with our recommendation to ensure that the development of the cash forecasting model includes the capabilities to forecast (1) required cash levels, (2) cash balances, (3) disbursements, and (4) receipts based on sales. DOD also concurred with our recommendation to monitor accounts receivable balances and cash outlay rates to identify anomalies and their causes so that corrective actions can be taken.

Comments From the Department of Defense

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COMPTROLLER

MAY 14 1998

Mr. Gene L. Dodaro
Assistant Comptroller General
Accounting and Information Management Division
General Accounting Office
Washington, D.C. 20548

Dear Mr. Dodaro:

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) draft report, "AIR FORCE SUPPLY MANAGEMENT: Analysis of Activity Group's Financial Reports, Prices, and Cash Management" dated April 6, 1998 (GAO 511635/OSD Case 1584).

DoD concurs with the overall comments and recommendations in the report. Detailed comments are provided in the enclosure. As a follow-on to the Working Capital Fund Study of September 30, 1997, three new groups are studying ways to implement many of the proposed corrective actions. This includes changing the method for calculating inventory valuations and cost of goods sold from latest acquisition cost to historical cost, new methods of accounting for Depot Level Reparable materials, and improving financial statement reporting. In addition, we are working with the Defense Finance and Accounting Service to develop better cash models and more accurate cash reporting.

The Air Force is taking actions to correct the deficiencies noted. They have been working with their customers to ensure that sufficient funds are available to support the current program. They are also taking steps to improve reporting for individual Air Logistics Centers.

The above actions plus the implementation of your recommendations should improve the reliability and accuracy of the Air Force's Supply Activity groups operations.

Thank you for the opportunity to comment on this report.

Sincerely,

William J. Lynn

Enclosure

GAO Draft Report – Dated April 6, 1998
(GAO Code 511635) OSD Case 1584

"AIR FORCE SUPPLY MANAGEMENT: Analysis of Activity Group's Financial Reports, Prices, and Cash Management"

RECOMMENDATIONS

- RECOMMENDATION 1: The GAO recommended that the Secretary of Defense develop a detailed implementation plan to ensure that the actions identified by DoD in September 1997 to correct the financial reporting problems are carried out in a timely manner. The GAO recommended that the plan should (1) identify specific actions that need to be taken including modification of existing systems or development of new systems, (2) establish milestones, (3) clearly delineate responsibilities for performing the tasks in the plan, and (4) ensure compliance with accounting standards on accounting for inventory and related property. (pp. 11-12 & 35/ GAO Draft Report)

  DoD RESPONSE TO THE DRAFT REPORT: Concur. Plans to accommodate the GAO recommendations are in the process of being developed. The OSD Revolving Funds Directorate has established three working groups that will develop specific implementation and execution plans and procedures for financial reporting. These three groups are looking at changing the method of inventory valuations from latest acquisition or repair cost to historical cost. This will impact cost of goods sold calculations used in calculating Net Operating Results. The two other groups are looking at accounting and reporting of Depot Level Repairable Material and Financial Statement reporting. The Revolving Funds Directorate is also working with the Defense Finance and Accounting Service (DFAS) to develop better cash management tools. These groups will meet throughout the summer with reports expected later this year. In addition, many of the recommendations made in the Working Capital Fund Study of September 30, 1997, are being included in the updated Financial Management Regulation 7000.14R. These changes are scheduled for publication this summer. The results of ongoing studies will be incorporated in the next Financial Management Regulation update.

- RECOMMENDATION 2: To help link information contained in the accounting report to budget formulation, the GAO recommended that the Secretary of the Air Force direct a reconciliation of the net operating results in the 1307 accounting report to the reported actual net operating results in the budget justification report and used for budgeting purposes. (pp. 12 & 38-39/GAO Draft Report)

  DoD RESPONSE TO THE DRAFT REPORT: Concur. Air Force and DFAS will work together to complete this action. In the update to the Financial Management Regulation, additional lines have been added to the budget format to help in explaining differences between net operating results/accumulated operating results between budget and accounting reports.

- RECOMMENDATION 3: The GAO recommended that the Secretary of the Air Force assess the impact of price changes on customers to determine whether readiness problems are

resulting in fiscal year 1998 and take funding reallocation actions, as appropriate, to meet the highest priority needs. (pp. 12 & 54/GAO Draft Report)

DoD RESPONSE TO THE DRAFT REPORT: Concur. The Air Force has already begun the process of reallocating resources to customers to ensure program integrity.

- **RECOMMENDATION 4:** The GAO recommended that the Secretary of the Air Force direct the Air Force Materiel Command Commander to develop and implement procedures to ensure that the prices that are established for individual inventory items are consistent with the composite prices developed and approved by the Office of the Under Secretary of Defense (Comptroller) during the budget process. (pp. 12 & 54/GAO Draft Report)

  DoD RESPONSE TO THE DRAFT REPORT: Concur

- **RECOMMENDATION 5:** The GAO recommended that the Secretary of the Air Force direct the Commander, Air Force Materiel Command to ensure that the development of the cash forecasting model includes the capabilities to forecast (1) required cash level, (2) end-of-period cash position on a weekly, monthly, or annual basis, and (3) disbursements to be made in future years based on when vendors are scheduled to deliver items to Supply Management Activity Group and the prices charged by the vendors, and (4) receipts based on SMAG's sales. (pp. 12 & 67/GAO Draft Report)

  DoD RESPONSE TO THE DRAFT REPORT: Concur

- **RECOMMENDATION 6:** The GAO recommended that the Secretary of the Air Force direct the Commander, Air Force Materiel Command to monitor accounts receivable balances and cash outlay rates to identify anomalies and their causes so that corrective actions can be taken. (pp. 12 & 68/GAO Draft Report)

  DoD RESPONSE TO THE DRAFT REPORT: Concur. Processes are being reviewed and corrective actions being taken.

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